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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE JOINT APPLICATION OF WILLOW VALLEY WATER CO., INC. AND EPCOR WATER ARIZONA INC. FOR APPROVAL OF THE SALE OF ASSETS AND TRANSFER OF CERTIFICATE OF CONVENIENCE AND NECESSITY.

DOCKET NO. W-01732A-15-0131
DOCKET NO. W-01303A-15-0131

STAFF'S CLOSING BRIEF

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby files its opening brief in the above-captioned matter. On any issue not specifically addressed in this brief, Staff maintains its position as represented in its testimony.

I. INTRODUCTION.

Willow Valley Water Company ("Willow Valley") and EPCOR Water Arizona Inc. ("EPCOR") filed a joint application for the sale of assets and transfer of the certificate of convenience and necessity of Willow Valley to EPCOR. In addition to requesting approval of the sale and transfer, EPCOR requested an acquisition adjustment mechanism to allow it to recover the difference between Willow Valley's rate base and the purchase price.

Willow Valley is a Class C water utility located near EPCOR's Mohave Water District. Willow Valley's ultimate parent company is Global Water Resources, Inc. ("Global"). Willow Valley currently serves approximately 1,620 connections in its existing service area of approximately 3.5 square miles. EPCOR is a Class A an Arizona public service corporation, authorized to provide water service in nine districts in Arizona. Among the water districts operated by EPCOR are the Mohave and North Mohave Water Districts, located approximately ten miles north of Willow Valley's certificated service area. EWAZ currently serves approximately 128,000 water customers throughout Arizona, including approximately 16,000 in its Mohave Water District and 2,000 in its North Mohave Water District.

The Applicants executed their agreement on March 23, 2015, and plan to close the transaction within 30 days after the Commission's final, non-appealable approval of the Application.[1] EWAZ will pay the full purchase price in cash.[2]

Staff recommends approval of the application, subject to several conditions: (i) that the Commission deny any recognition of any acquisition premium or incentive, (ii) that EPCOR be put on notice that Willow Valley should work towards a balanced capital structure and that a hypothetical capital structure may be deemed appropriate in a future rate proceeding if EPCOR fails to do so; (iii) that EPCOR continue to comply with all decisions, and more specifically the requirements of Decision No. 74364 which requires annual reporting of the Willow Valley water losses until such time as annual water losses are less than 10 percent. Staff further recommends that EPCOR prepare a water loss reduction report or a cost benefit analysis if EPCOR believes that it would not be cost effective to reduce water loss to less than 10% and file it as a compliance item within 90 days of the effective date of the order in this matter, if the transaction is approved.

The major disagreements in this case are the treatment of accumulated deferred income taxes ("ADIT") and the recognition of some type of acquisition premium or incentive.

II. ACCUMULATED DEFERRED INCOME TAX.

Willow Valley currently has an ADIT balance of approximately $260,000, the balance which would not transfer to the buyer.[3] ADIT reflect the timing difference between when income taxes are calculated for ratemaking purposes and the actual federal and state income taxes paid by the company.[4] The timing difference is primarily due to the fact that straight line depreciation is used for ratemaking purposes, whereas accelerated depreciation is used for income tax reporting purposes.[5] ADIT is a benefit to ratepayers because it is usually a deduction to rate base. Staff had initially recommended that EPCOR create a regulatory asset in order to preserve the benefit to the rate payer.

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1 Exhibit EWAZ-2 at 3.
2 *Id.* at 4.
3 Becker Direct Test., Ex. S-5 at 9.
4 *See* Decision No. 69164 at 5.
5 Michlik Direct Test., Ex. R-7 at 20.

the Internal Service Revenue regulations regarding normalization. Staff withdrew its recommendation.[6]

RUCO's witness, Ralph Smith, testified extensively on the issue of ADIT. Mr. Smith agreed with Staff that the transfer of the ADIT balance could pose a problem with the IRS regulations regarding ADIT.[7] Mr. Smith also suggested that even creating a regulatory liability in the same amount could also pose a problem.[8] The risk of transferring the ADIT balance or creating a regulatory liability could cause EPCOR to lose the ability to take accelerated depreciation.[9] In Mr. Smith's opinion, an option would be for EPCOR to request a private letter ruling from the IRS to determine if the proposed treatment of ADIT as a regulatory liability would violate the IRS regulations on normalization.[10] Because of the risk of running afoul of the IRS regulations on normalization, Staff withdrew its recommendation that the ADIT balance of approximately $260,000 be treated as a regulatory liability.

III. ACQUISITION PREMIUM.

EPCOR has requested an acquisition adjustment mechanism or incentive that is designed to capture the price paid in excess of the rate base.[11] According to EPCOR, this methodology would serve as a template to be used in other similar dockets.[12] The Company has proposed that as it makes investments into the system to address Willow Valley's water loss issue, once those investments are placed into service, EPCOR would file a rate case to include the capital investment plus a 20% premium that would represent the incentive, then computing a separate revenue requirement to be recovered over 15 years.[13]

According to the exhibit attached to the rebuttal testimony of Company witness Sarah Mahler, the 20 percent is calculated in the amount of the capital invested, which is estimated by EPCOR to be $1 million.[14] That 20 percent would be multiplied times the return on equity that is established in the

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6 Carlson Surrebuttal Test., Ex. S-6 at 4.
7 Smith Surrebuttal Test., Ex. R-1 at 19.
8 Tr. at 86-87.
9 Carlson Surrebuttal Test., Ex. S-5 at 4.
10 Smith Surrebuttal Test., Ex. R-1 at 25; Tr. at 27:7-17.
11 Mahler Rebuttal Test., EWAZ-4 at 7.
12 Tr. at 12:15-25; 318:1-16.
13 Mahler Rebuttal Test., EWAZ-4 at 8.
14 *Id.* at Ex. SM-1.

rate case. The result of that calculation would be the income that would be authorized per year. The income amount would then be multiplied by the gross revenue conversion factor. This generates the amount of revenue that is required from customers. While the amount paid in excess of the rate base is not included in rate base as part of the proposed mechanism, the mechanism is designed to capture the difference between what EPCOR paid and the amount of the rate base.[15] Staff has recommended that no acquisition premium or any type of incentive be granted in this transaction.

An acquisition premium has been defined as an adjustment for the difference between the depreciated original cost of a utility and the purchase price for that utility.

In Decision No. 68412, the Commission stated:

> In traditional rate making, the Commission allows a rate of return on the assets used and useful in the provision of utility service. When an entity purchases utility assets above their book value, the amount of the difference between the purchase price and the book value is an acquisition adjustment. The Commission only allows a return on an acquisition adjustment in extraordinary circumstances.[16]

The Commission, *In the Matter of Northern Sunrise et al.*, approved the sale and transfer of water utility assets and cancellation of the CC&Ns of Miracle Valley Water Company, Inc., Cochise Water Co., Horseshoe Ranch Water Company, Crystal Water Company, Mustang Water Company, Coronado Estates Water Company and Sierra Sunset Water Company (collectively "McLain Water Systems"); and conditionally granted the applications of Northern Sunrise Water Company and Southern Sunrise Water Company for new CC&Ns to provide water utility service to the former McLain Water Systems. The Commission approved the creation of a regulatory asset to allow the recovery the costs associated with the acquisition by Algonquin Water Resources of America ("Algonqiun"), of the McLain water systems owned by Johnny McLain, ("McLain Systems").[17] The McLain Systems were in serious disrepair and under the management of an interim operator. Algonquin acquired the McLain Systems out of bankruptcy. Algonquin (now Liberty Utilities) estimated its acquisition costs to be approximately $300,000 and requested recovery of those costs.

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[15] Tr. at 405:9-25.

[16] In the Matter of the Determination of a Rate Base Value for Miracle Valley Water Company et al., Docket No. W-01646A-05-050, Decision No. 68412.

[17] Docket No. W-20453A-06-0251, Decision No. 68826.

The Commission stated: "If ever there was a situation that merited such treatment this is the case."[18] The Commission allowed the creation of a regulatory asset to capture the costs attributable to the acquisition by Algonquin and ordered that in the next rate case, once it was verified that the costs had been incurred, the costs would be recoverable.

In the Matter of Citizens Utilities Company, the Commission deferred consideration of an acquisition premium until the next rate case. Staff had recommended and the Commission agreed that there should be clear, quantifiable and substantial net benefits to ratepayers the result from an acquisition that could not have been realized absent the transaction.[19]

The Commission allowed for the inclusion of an acquisition adjustment in rate base when it approved the purchase by Sun City West Water of Cool Well Water Company.[20] Cool Well was a small water company that had been operating at a loss for many years and providing unreliable service. In that case, Staff recommended an acquisition adjustment be allowed to encourage consolidation of small water companies into larger ones. The Commission approved the acquisition adjustment in that matter.[21]

The instant case involves the acquisition of one well-qualified company to another well-qualified company.[22] Willow Valley and EPCOR are well-run, well-capitalized companies. The testimony has shown that Willow Valley is currently providing adequate, reliable service and is operating in compliance with all regulatory requirements.[23] Willow Valley has a significant water loss issue in one of its systems.[24] The Commission has consistently required companies to remedy water loss if such loss is greater than 10 percent. EPCOR, in remedying the Willow Valley water loss, would be performing exactly as to be expected of a Class A utility. EPCOR has been unable to quantify any substantial benefits to the ratepayers. In response to a Staff Data Request, EPCOR could not quantify any benefits that would result because of the transfer of ownership.[25] EPCOR testified

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[18] *Id.* at 11.
[19] Docket No. W-01032A- 00-0192, Decision No. 63584 at 11.
[20] *See* discussion in Decision No. 60172 at 16-17; Decision No. 56551.
[21] *Id.*
[22] *See* Willow Valley's Response in Opposition to RUCO's Request Reschedule Hearing at 4.
[23] Tr. at 145:7-22.
[24] Liu Direct Test., Ex. S-8 at 2.
[25] Data Request STF GWB 1.8, Ex. S-2; Tr. at 291:15-25; 292:1.

that it believed that because of its physical proximity to the Willow Valley service area, combined with the savings to be gained in operational expenses because of the reduction of water loss would benefit rate payers. In Staff's opinion, EPCOR has not demonstrated significant benefits to the ratepayer to warrant any type of acquisition premium, incentive or adjustment.

IV. CONCLUSION.

Staff recommends approval of the transaction with conditions. Staff would urge the adoption of its recommendations.

RESPECTFULLY SUBMITTED this 7th day of December, 2015.

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